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Canada Housing Market Outlook: More Struggles Ahead

Introduction

Canada's housing market has passed its previous peak and is in a period of declining house prices, reduced home sales, and a softer market overall. The new environment is because of a combination of interest rate tightening by the Bank of Canada and plunging affordability. Nevertheless, the effects have been uneven across provinces; overvalued markets such as Toronto, Hamilton and Vancouver experienced the most significant declines compared with year-ago levels.

The baseline forecast anticipates that median house prices will fall 15% from their mid-2022 peak before bottoming out at the start of 2024, with the Prairies retaining better affordability than other markets. Given that previous house price appreciation was outpacing income growth and also starting to stretch household debt service ratios, the downward shift in house price appreciation will not be bad news. In response to the correction in house prices, the current, feverish pace of building activity should subside, returning in line with its pre-pandemic average.

Canada Housing Market Outlook: More Struggles Ahead

BY BRENDAN LACERDA, ABHILASHA SINGH, SEBASTIAN MINTAH, GEORGE PINEL

Canada's housing market has passed its previous peak and is in a period of declining house prices, reduced home sales, and a softer market overall. The new environment is because of a combination of interest rate tightening by the Bank of Canada and plunging affordability. Nevertheless, the effects have been uneven across provinces; overvalued markets such as Toronto, Hamilton and Vancouver experienced the most significant declines compared with year-ago levels.

The baseline forecast anticipates that median house prices will fall 15% from their mid-2022 peak before bottoming out at the start of 2024, with the Prairies retaining better affordability than other markets. Given that previous house price appreciation was outpacing income growth and also starting to stretch household debt service ratios, the downward shift in house price appreciation will not be bad news. In response to the correction in house prices, the current, feverish pace of building activity should subside, returning in line with its pre-pandemic average.

Recent Performance

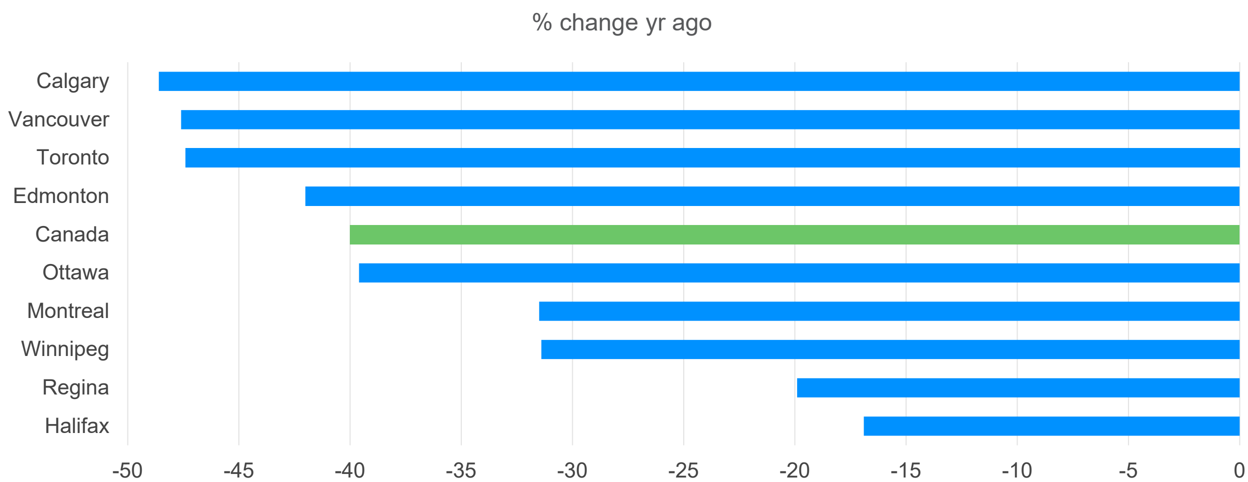
Canada's housing market is taking it on the chin because of higher mortgage rates and plunging affordability. The five-year mortgage rate has spiked to 5.8%, up more than 250 basis points since the start of 2022, its highest level since December 2008. As a result, the ratio of average homeownership costs—of which mortgage debt service is the largest component—to average household disposable income, as measured by the Bank of Canada's affordability ratio, has recently risen to its highest level since the late 1980s.

The precipitous decline in existing-home sales has eased in recent months, rising 2.3% in February from the previous month. However, they are still down 40% from the heated levels a year ago. That leaves sales volumes running close to a pace last seen during the Great Recession (excluding the pandemic lockdown period). High interest rates drove away buyers and dissuaded homeowners from listing their homes for sale and giving up their ultra-low mortgage rates.

While sales have swung wildly, new listing flows have slowed as well, reinforcing the fact that there is little forced selling underway. The months' supply of existing homes is hovering above four months—more than double the level at the start of 2022. This was mostly driven by the decline in existing-home sales in 2022.

While the national existing-home sales decline is notable, there is significant variation across geographies with Toronto and Vancouver both experiencing 47% declines from their year-ago levels (see Chart 1). High mortgage rates are amplifying the strain on affordability in these markets. The sales decline in Montreal was modest during the summer but has picked up speed and is close to the nationwide average.

Chart 1: Sales Activity Takes a Big Hit in Toronto and Vancouver



Sources: Canadian Real Estate Assn., Moody's Analytics

The metro areas in the Prairie provinces have also been affected. Sales slowed in Calgary compared with last year but remain consistent with long-term trends. Existing-home sales remain solid in Edmonton despite the softening; sales are still tracking above pre-pandemic levels. In Halifax, home sales declined approximately 17% compared with a year earlier, while Canada experienced a 40% decrease.

House prices retreat

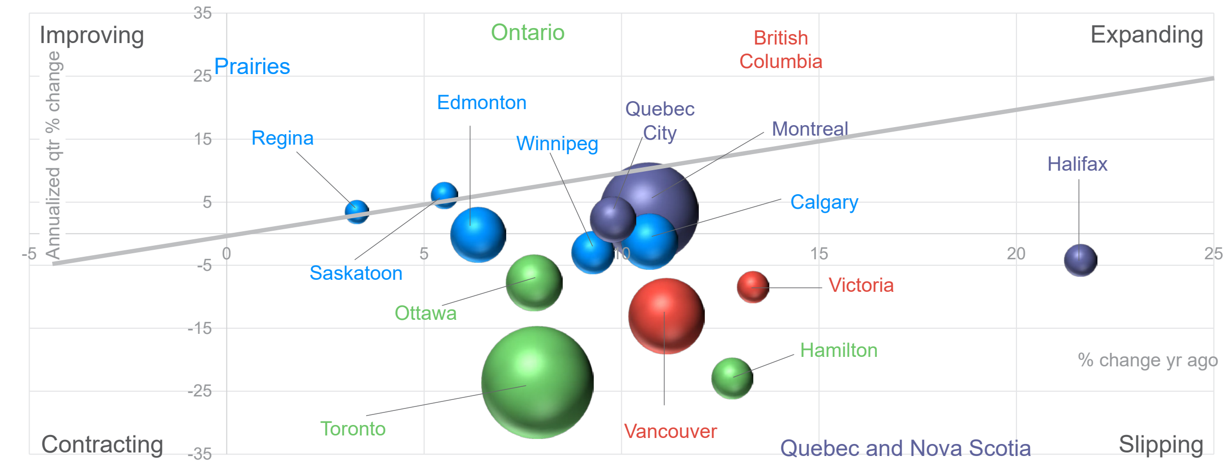
The summer months brought an end to the meteoric rise in house prices. The RPS Metropolitan Composite Index reported house prices fell 0.3% from January to February, marking the ninth consecutive month of price contraction. The index, which tracks the 13 largest metropolitan areas in Canada, saw some of its largest price declines since the Great Recession. Year-over-year price appreciation peaked in March and is quickly coming in, eroding the equity gains seen within the last year. In February, prices decreased by 4.5%, a sharp contrast to the 18.5% increase in the same month of the previous year. However, declining prices have done little to help affordability issues as the five-year mortgage rate is around 6%, adding hundreds of dollars to the average monthly mortgage payment.

The swing in the housing market during the past year has been nothing short of spectacular. However, there have been monumental differences across regions. Metro areas in Ontario and British Columbia, where housing markets are the most overvalued and unaffordable, registered the first and fastest declines (see column two of Table 1).

The slowdown is even more evident when examining house price dynamics in the six months from July to January, as shown in Charts 2 and 3. The vertical axis measures house price growth for one quarter, the horizontal

Chart 2: Overvalued Markets Fall First

Composite index, 1-yr vs. 1-qtr performance, Aug 2022

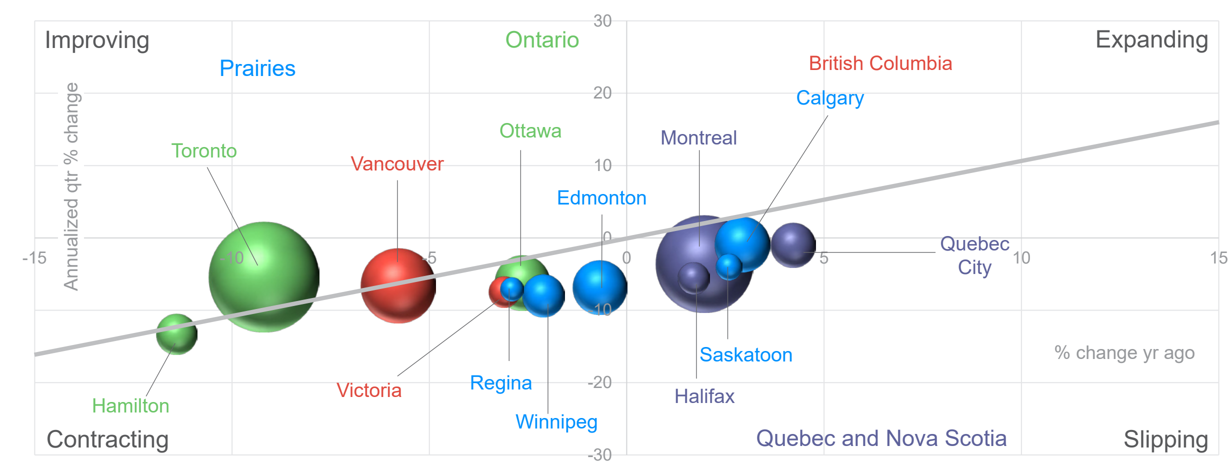


Sources: RPS, Moody's Analytics

Note: Bubble size indicates # of households

Chart 3: Prices Retreat Everywhere, Albeit Slowly

Composite index, 1-yr vs. 1-qtr performance, Jan 2023



Sources: RPS, Moody's Analytics

Note: Bubble size indicates # of households

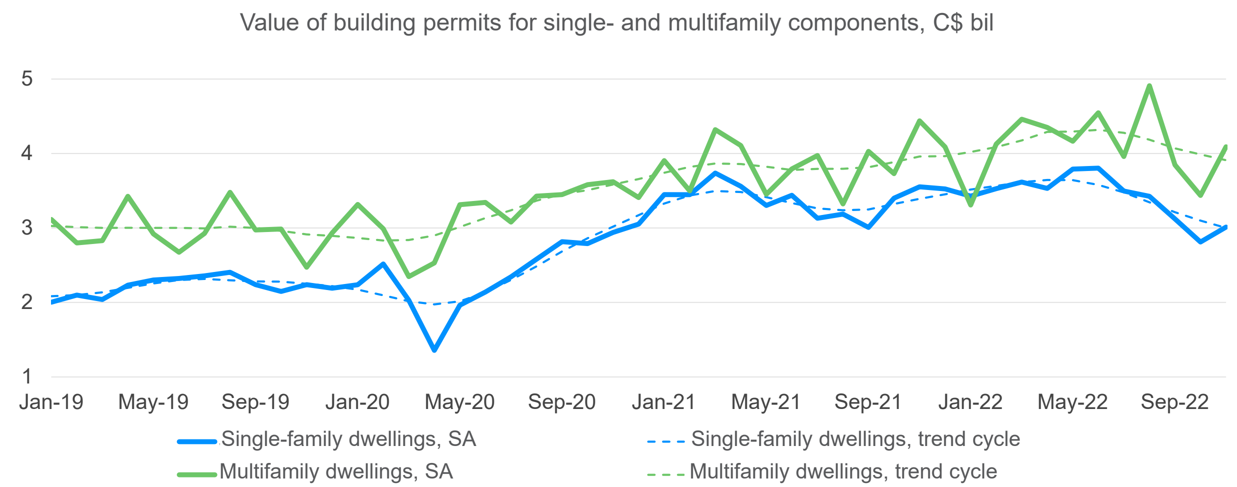
axis measures price gains for the year, and the area of each bubble is proportional to the total number of households in the metro area. From May to August, house prices in Toronto, Vancouver, and nearby metro areas such as Hamilton slipped. Other metro areas experienced less of a change. Medium-size metro areas such as Winnipeg, Halifax and Quebec City slowed slightly but still made solid if unspectacular price gains. By February, house prices had fallen in all the metro areas, with prices below their year-ago levels in all metro areas except Montreal, Calgary, Quebec City, Halifax and Saskatoon.

Metrics

The value of building permits is a useful barometer for the health of the housing market and can be a leading indicator for the broader economy. Construction tends to pick up at the advent of economic upswings and conversely begins to taper off as a downturn materializes. As economic growth continues to slow and with a mild technical recession on the table, we can expect permits to drop in response.

As seen in Chart 4, after sustained upward momentum during the first half of 2022, the total value of residential building permits trended downward, particularly in the fourth quarter. Building permits are volatile; swings such as February's uptick should be taken with a grain of salt and viewed within a wider context of multi-month movements. The recent downward pressure on permit values could be partially explained by seasonality as construction tends to decline in winter. In February, the reading was 15.2% lower than it was a year earlier after a 4.1% and 9.6% decrease in January and December, respectively. Further, indicators across housing metrics and broader macroeconomic variables suggest that there is more to the decline than just inclement weather conditions.

Chart 4: Residential Permit Values Trend Downward



Sources: Statistics Canada, Moody's Analytics

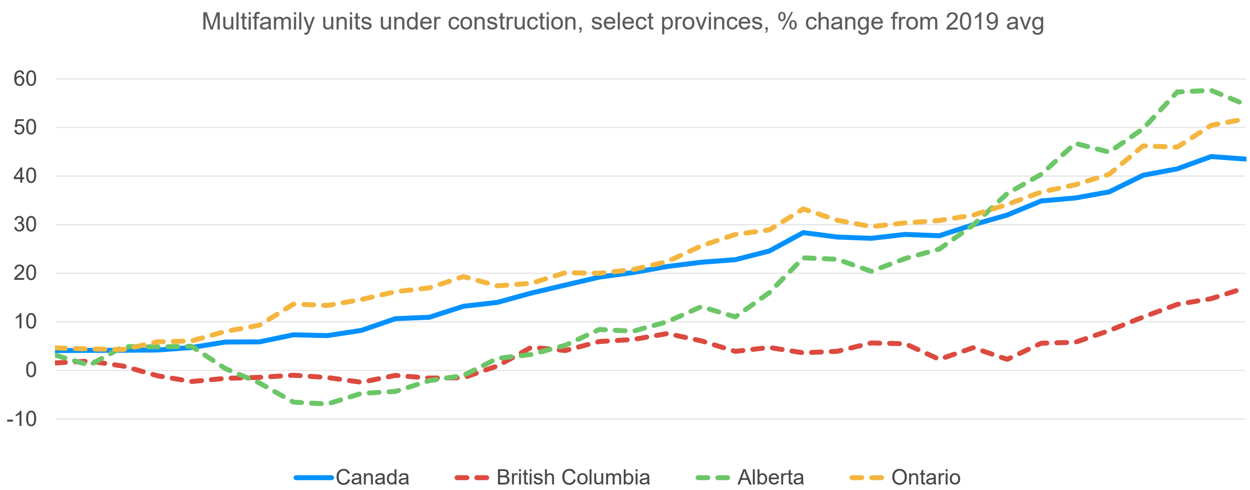
Chief among them is the fact that the housing market is notably interest-rate sensitive. Despite the Bank of Canada's forward guidance signaling a pause, its benchmark rate rests at a 15-year high. As a result, elevated mortgage rates are pricing many would-be homeowners out of the market, taking pressure off housing demand. Further, high rates are limiting the availability of capital and investment for construction projects—a supply-side constraint.

Nominal permit prices are still elevated above their pre-pandemic long-run average but adjusting for inflation takes a lot of the air out of these prices. Total permit value in constant 2012 dollars for residential and commercial units has fallen in line with its pre-2020 trend. Further, a look at the residential permit count during the past three years reveals that residential permit volume fell below trend in the third quarter of 2022 and remains there.

All told, the pace of permit issuance is responding to slowing economic growth and will continue to decrease over the near term, dispelling the notion that seasonality is solely responsible for recent weakness.

Dwindling permit volume will translate into a reduction in housing starts in coming quarters. Residential housing starts climbed rapidly during much of the first half of 2022, pushing above trend in the second quarter. The housing market was still hot at the beginning of 2022; thus, the strong pace of starts. Supply-side constraints in 2021 may have also delayed many projects from breaking ground, leading to a backlog and subsequent surge in starts during the first half of 2022. As a result, the number of homes under construction in the fourth quarter topped 378,000—a historic high with the number of multifamily units under construction 40% greater than 2019's average (see Chart 5). Starts remained elevated over much of 2022 but rapidly declined in the fourth quarter, falling below their 12-month moving average as a result of the evaporating permit pool.

Chart 5: Wave of New Homes Set to Hit Market



Sources: Canada Mortgage and Housing Corp., Moody's Analytics

A look at the absorption rate of new homes on the market sheds further light on the demand side of the story. According to Canada Mortgage and Housing Corp. data, the "absorption-rate-at-completion" for single-family units has been steadily falling since last summer, while the number of single-family units that have been "completed-yet-unabsorbed" has been gradually trending upward. This implies that demand for single-family units is easing, responding to the Bank of Canada's ambitious tightening cycle along with diminishing affordability. Judging by the absorption data for multifamily units, demand has not been hurt as much yet, suggesting the apartment rental market will be relatively less affected by higher interest rates than the mortgage-linked homeownership market.

Ultimately, when looking through the noise, it is evident that the housing market is cooling. With a sizable number of permits and starts still in the pipeline and projects underway, the housing stock will continue to build in the next few months. The worsening near-term economic outlook will be a major headwind for the market on all fronts.

Foreign buyers' prohibition

In June, the Canadian Parliament passed a law banning residential property purchases by people who are not Canadian citizens or permanent residents. Formally known as the Prohibition on the Purchase of Residential Property by Non-Canadians Act, this law officially took effect on January 1 and will end in 2025. Similar policies enacted at the provincial level show the ban is unlikely to significantly slow price appreciation.

Debate swirled around the effects of foreign purchasers speculating on property. Proponents claimed foreign speculators artificially boosted prices by purchasing large properties in hot housing markets, with return on investment being the sole focus. This harmed affordability for Canadian residents.

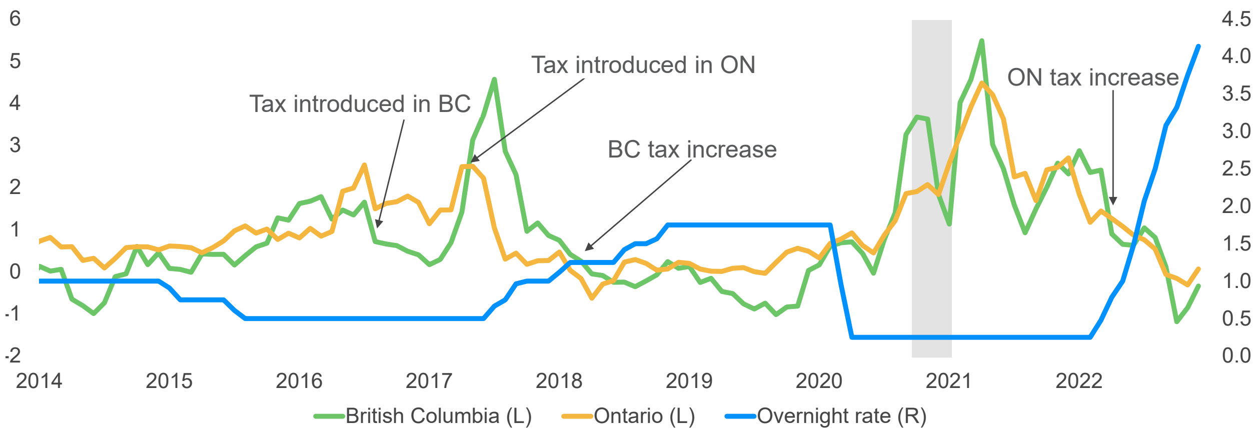
Taxes on foreign buyers enjoy broad domestic political support. In 2016, British Columbia introduced a 20% tax on foreign buyers and a 0.5% tax on speculative and vacant properties. Polling shows the tax garnered 90% favorability, with 65% of respondents blaming high housing prices on foreign speculators—nearly triple the amount that cited low interest rates as a primary factor.

We can use the British Columbia tax and a similar tax in Ontario passed in 2017 as a natural experiment for estimating how the 2023 nationwide ban will affect house prices. In addition to the initial taxes, British Columbia and Ontario have since raised the tax as well.

Chart 6 shows the change in house prices for the provinces alongside the Bank of Canada's overnight target rate. Of the two provincial taxes and their increases, only the introduction of the Ontario tax appears to be timed with a slowdown in prices. However, even this is spurious. First, it predates a large drop in the broader housing market by only a few months. Second, it corresponded with forward guidance about rate hikes. The remaining three policy changes did not noticeably change the momentum of house prices.

Chart 6: Foreign Buyers Tax Has Little Impact

% change qtr ago in house prices (L) vs. Bank of Canada overnight target rate, % (R)



Sources: Statistics Canada, Moody's Analytics

Econometric analysis reinforces this intuition. We used the timing of the British Columbia and Ontario taxes to see if the introduction of each tax affected the housing market in these provinces in a unique way. Neither the taxes nor their later increases changed the trajectory of housing prices in British Columbia and Ontario relative to other provinces.

This result conforms with theoretical predictions. Monetary policy has an established empirical relationship with house prices. In the periods leading up to the British Columbia, Ontario and nationwide policies, the Bank of Canada kept interest rates low, driving up prices. Then, once the bank signaled tightening, house price inflation decelerated.

Second, it should be noted that the share of nonresident owners is marginal. Nonresident owners account for 5% and 3.4% of property owners in Vancouver and Toronto, respectively. Likewise, and most relevant for the 2023 nationwide ban, the areas that saw the quickest appreciation after the pandemic were not markets that historically experienced high levels of foreign investment.

Finally, the timing of the foreign buyers ban is ill-conceived. While the bill was passed during the height of house price inflation, it did not take effect until January 1. House prices have already begun to drop, and more declines are coming. For potential speculators, shrinking profits are a more powerful disincentive.

The macro outlook

Economic growth is expected to rapidly decelerate in the next six months as households exhaust their savings, elevated interest rates bite into consumer spending, and businesses dial back hiring in response to soft demand. In turn, a mild and brief technical recession is expected to unfold, though significant GDP contractions are avoided. High interest rates, the primary driver of the current business cycle, will weigh down the economy enough that GDP pulls back slightly, but borrowing costs alone are unlikely to provoke a full-fledged recession.

The impending slowdown should also contrast with previous downturns as the negative spillover to the labor market will likely prove more muted than usual. Coming on the heels of a period when firms experienced significant hiring challenges and high rates of job switching, managers will be reticent to commence significant layoffs. Most of the expected increase in unemployment during the next year will result from new labor-market entrants discovering that firms have suspended new hiring.

While the baseline forecast anticipates that the economy will be able to navigate this rough patch with minimal damage, the economy will be extremely vulnerable to any external shocks during this time. In this weak state, even the slightest shocks could push the economy into a more pronounced recession.

Most notable, the baseline forecast envisions that CPI inflation will cool further as the year goes on. Falling energy prices and base effects have spurred inflation's initially rapid deceleration; however, progress is likely to slow. Core inflation pivots more slowly given the elevated pace of wage growth, but falling core goods prices provide enough downward pressure to help inflation decelerate. Improved supply chains and softer goods demand will also help ease price pressures.

In turn, the improvement in inflation allowed the Bank of Canada to halt its interest rate increases in January. With its final hike, the overnight policy rate should hold at 4.5% throughout nearly all of 2023.

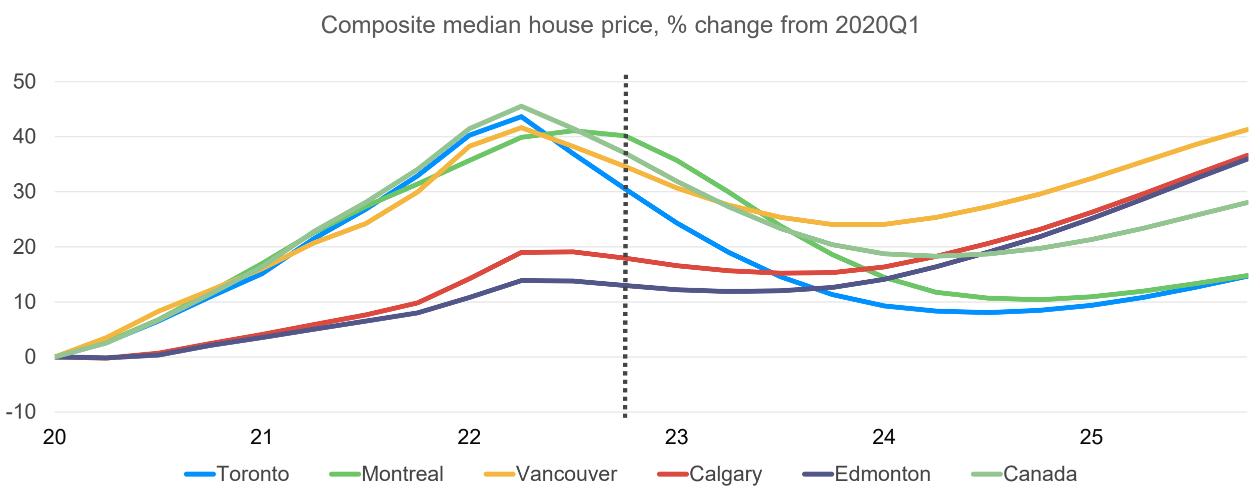
However, we do not expect the bank will maintain elevated rates for a protracted time. Historically, periods of overshooting interest rates tend to be short. History aside, the turn in the business cycle should shift policymakers' focus. With inflation subsiding, concerns will begin to mount about weak growth and a rising jobless rate.

Early in the second half of 2023, with inflation rapidly cooling and expectations building for a normalization of interest rates, consumer and business sentiment should begin to revive. Spending and investment will pick up, growth will reaccelerate, and the economy will shake off its sluggish start to the year.

The housing forecast

While the Canadian economy is likely to escape 2023 with only minor damage, the same cannot be said for the housing market. The rapid escalation of interest rates, sharp decline in affordability from two years of massive price increases, rising unemployment, and a swell of new supply should cause a steep drop in prices. All told, the national median house price is expected to fall 15% from its mid-2022 peak before bottoming out at the start of 2024 (see Chart 7). Prices have already dropped about 8%, implying half of the losses are still to come.

Chart 7: House Prices Retreat



Sources: RPS, Moody's Analytics

Sales activity has declined as prospective monthly mortgage payments have soared and buyer sentiment has cratered. Further, as prices have begun falling, potential buyers are becoming even more apt to wait in anticipation of additional price declines, which further depresses demand and prices.

However, this dynamic also implies that pent-up demand will build as interest rates peak in 2023. As economic growth resumes in late 2023 and into 2024, and interest rates start falling in 2024 as the Bank of Canada normalizes policy, the baseline forecast anticipates that price appreciation will recover quickly once the Bank of Canada begins normalizing rates.

Subsequently, the house price correction will cool the pace of building, returning it to its pre-pandemic average. The spike in prices since the start of the pandemic sent the speed of new construction to a record high. The significant amount of new supply coming on the market in 2023 will force developers to cut prices to clear unsold inventory. However, we do not expect a more severe contraction in homebuilding as further easing in global supply chains and cooling global property markets should help bring down the cost of building materials and new construction.

Further, Canada needs more homes to meet the rising demand created by the country's robust demographics. Canada set a record for new immigration in 2022 and has raised the allowance for new migrants in the years ahead.

The regional forecast

In line with slowing national appreciation, most of the metro areas are expected to undergo a price correction. House prices will fall in most metro areas, but overvalued markets will experience the greatest downward pressure on prices as demand for housing falls.

An unprecedented number of metro areas are overvalued, with prices exceeding their fundamental value by more than 10%. Serious overvaluation is not limited to Toronto or Vancouver but also includes the surrounding Golden Horseshoe region. By contrast, overvaluation is not a problem in the Prairies. Some of the undervalued housing markets, especially in Alberta and Saskatchewan, will do better mainly because they have retained better affordability. The Prairies had a much smaller runup in prices during the pandemic and also experienced weak price growth in years preceding it.

The fourth column of Table 1 shows the forecasts for house prices in the first quarter of 2024 on a year-ago basis. The strongest depreciation rates will be observed in smaller Ontario metro areas, including Greater Sudbury, Kingston, London, Barrie and Windsor, as well as Trois-Rivieres and Montreal in Quebec and Halifax in Nova Scotia. Of the large metro areas, we expect that only Montreal will see the steepest decline in prices, followed by Toronto. Meanwhile, house price depreciation will be modest in Calgary, Edmonton and Saskatoon. This reflects affordability conditions that are solid by historical standards and demographics—supported by massive immigration and a record inflow of nonpermanent residents.

The last column of Table 1 shows house price growth in the first quarter of 2025, where the inertial effects from historical house price growth are no longer expected to be as strong and forecasts are driven mainly by reversion to trend and by sensitivity to changes in mortgage rates. The correction for most of the metro areas will continue with house prices not recovering until late 2024. House price appreciation is expected to recover more quickly in Calgary, Edmonton and Saskatoon, advancing at a fast rate.

On average, Canadian metro areas will experience significantly slower house price growth during the next five years though the decelerations will be sharper for Montreal, while the Prairie metro areas will undergo price increases. The more pessimistic house price forecast is consistent with intended policy effects of the Bank of Canada to improve affordability and reduce mortgage risks, which will have at least partial success in the medium term.

Risks

Mortgage rates and housing affordability more broadly are the most salient short-term risks to the housing market. Monthly mortgage payments have risen to unaffordable levels for millions of households, particularly first-time homebuyers. Additional mortgage rate increases would reduce the pool of qualified buyers, causing house prices to fall.

Inflation remains a secondary risk to the outlook as the cost of essentials constrains spending on housing.

The primary upside risk to the outlook includes a significant improvement in inflation, which would support household budgets and allow the Bank of Canada to adopt a more rapid pivot that quickly returns the policy rate to its neutral level.

Table 1: Canada Subnational Forecast, House Price Value: Composite - Median value

	% change yr ago, 2022Q4	% change yr ago, 2023Q1	% change yr ago, 2024Q1	% change yr ago, 2025Q1
Alberta	7.22	3.70	1.25	9.30
Calgary, census metropolitan area	9.09	4.35	0.90	8.95
Edmonton, census metropolitan area	4.57	2.02	1.75	9.79
British Columbia	3.73	-4.68	-3.21	9.56
Abbotsford, census metropolitan area	-2.90	-15.24	-10.69	5.86
Kelowna, census metropolitan area	9.25	0.76	0.98	13.74
Vancouver, census metropolitan area	3.04	-5.27	-3.25	9.48
Victoria, census metropolitan area	5.66	-2.35	-2.13	9.20
Manitoba	2.38	-3.80	-5.32	6.25
Winnipeg, census metropolitan area	2.35	-3.99	-5.32	6.25
New Brunswick	14.05	3.37	-10.03	-0.63
Moncton, census metropolitan area	12.25	1.55	-6.61	6.01
Saint John, census metropolitan area	21.53	9.39	-13.46	-7.84
Newfoundland and Labrador	8.05	4.40	-2.07	4.10
St. John's, census metropolitan area	9.15	5.42	-2.07	4.10
Nova Scotia	10.95	-0.01	-16.27	-7.00
Halifax, census metropolitan area	11.94	0.27	-16.27	-7.00
Ontario	-0.63	-9.75	-12.05	-0.06
Barrie, census metropolitan area	-2.36	-15.01	-14.99	-0.74
Brantford, census metropolitan area	-2.02	-13.37	-13.73	-1.39
Greater Sudbury, census metropolitan area	8.04	-4.00	-13.43	-1.57
Guelph, census metropolitan area	-0.34	-9.38	-11.95	-0.30
Hamilton, census metropolitan area	-0.90	-12.60	-15.36	-2.38
Kingston, census metropolitan area	5.23	-1.93	-9.50	-0.03
Kitchener, census metropolitan area	-2.51	-13.42	-13.08	0.06
London, census metropolitan area	-0.28	-12.10	-15.05	-1.59
Ottawa-Gatineau, census metropolitan area	2.99	-2.76	-7.89	1.84
Oshawa, census metropolitan area	-1.90	-12.34	-11.80	0.30
Peterborough, census metropolitan area	-0.10	-8.63	-11.52	-1.95
St. Catharines-Niagara, census metropolitan area	2.56	-6.01	-11.99	-2.69
Thunder Bay, census metropolitan area	1.53	-7.95	-13.64	-1.07
Toronto, census metropolitan area	-1.97	-10.52	-11.83	0.33
Windsor, census metropolitan area	3.55	-8.15	-14.68	-2.85
Prince Edward Island	11.72	7.32	-12.20	-7.77
Quebec	6.98	0.11	-15.16	-5.03
Montreal, census metropolitan area	5.83	-1.19	-17.20	-6.57
Quebec, census metropolitan area	9.61	5.54	-4.49	2.70
Saguenay, census metropolitan area	4.53	0.68	-6.21	2.01
Sherbrooke, census metropolitan area	15.89	8.40	-10.99	-5.74
Trois-Rivieres, census metropolitan area	10.27	0.35	-16.82	-6.05
Saskatchewan	-0.56	-3.33	-1.64	9.99
Regina, census metropolitan area	-2.53	-5.65	-4.37	8.48
Saskatoon, census metropolitan area	3.87	0.82	0.18	10.93

Sources: RPS, Moody's Analytics

About the Authors

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The RPS – Moody's Analytics House Price Forecasts are based on fully specified regional econometric models that account for both housing supply-demand dynamics and long-term influences on house prices such as unemployment and changes in mortgage rates. Updated monthly and providing a 10-year forward-time horizon, the forecasts are available for the nation overall, its 10 provinces and for 33 metropolitan areas, and cover three property style categories, comprising single-family detached, condominium apartments and aggregate, in a number of scenarios: a baseline house price scenario, reflecting the most likely outcome, and six alternative scenarios.

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